Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Kelley | Analyst: Jeani Brent | Bill Number: SB 403

Related Bills: See Legislative History | Telephone: 845-3410 | Introduced Date: 02/12/1999

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Enterprise Zone/Sales or Use Tax Credit/Qualified Property Includes Agricultural Drain Water Treatment Facilities

SUMMARY

Under the Bank and Corporation Law, this bill would revise the definition of qualified property for purposes of the enterprise zone sales or use tax credit to include agricultural drain water treatment facilities.

EFFECTIVE DATE

As a tax levy, this bill would apply to income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

AB 51, SB 84, AB 356 (1999); AB 3 (Stats. 1998, Ch. 1012), AB 2798 (Stats. 1998, Ch. 323), AB 2809 (Stats. 1998, Ch. 1039); AB 69, AB 82, AB 638, AB 809, AB 1217 (Stats. 1997, Ch. 602), SB 200 (Stats. 1997, Ch. 609), SB 635, SB 965 (Stats. 1997, Ch. 603); AB 2456 (1996), AB 296 (Stats. 1996, Ch. 953), SB 715 (Stats. 1996, Ch. 952), SB 2023 (Stats. 1996, Ch. 955); SB 712 (Stats. 1995, Ch. 494); AB 2206 (Stats. 1994, Ch. 853), SB 1438 (Stats. 1994, Ch. 754), SB 1770 (Stats. 1994, Ch. 755).

PROGRAM HISTORY/BACKGROUND

California has four types of economic development areas that have similar tax incentives:

- Enterprise Zones,
- Local Agency Military Base Recovery Areas (LAMBRA),
- Targeted Tax Area (TTA), and
- Manufacturing Enhancement Areas (MEA)

The following table shows the incentives available to each of the economic development areas.

Types of Incentives	EZ	LAMBRA	TTA	MEA
Sales or Use Tax Credit	X	X	X	
Hiring Credit	X	X	X	X
Employee Wage Credit	X			
Business Expense Deduction	X	X	X	
Net Interest Deduction	X			
Net Operating Loss	X	X	X	

Board Position:

____ S   ____ NA   ____ NP
____ SA   ____ O   ____ NAR
____ N   ____ OUA   X PENDING

Department Director: **Gerald Goldberg** Date: **3/-23/1999**

SPECIFIC FINDINGS

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an enterprise zone. Using specified criteria, the Trade and Commerce Agency (TCA) designates enterprise zones from the applications received from the governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may be extended to 20 years), and TCA has designated each of the 39 enterprise zones authorized under existing law. When an enterprise zone expires, TCA is authorized to designate another in its place.

Under the Personal Income Tax Law and the Bank and Corporation Tax Law, existing state law provides special tax incentives for taxpayers conducting business activities within an enterprise zone. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. In addition, a wage credit may be claimed by specified employees of businesses operating within an enterprise zone. See attachment A for a detailed discussion of each tax incentive.

The enterprise zone sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property purchased for exclusive use in an enterprise zone. Qualified property is defined as:

1. Machinery and machinery parts used for :
   A. manufacturing, processing, combining, or otherwise fabricating a product;
   B. the production of renewable energy resources; or
   C. air or water pollution control mechanisms.
2. Data processing and communication equipment.
3. Motion picture manufacturing equipment.

This bill, under the Bank and Corporation Tax Law, would revise the enterprise zone sales or use tax credit definition of qualified property. The revision would include “agricultural drain water treatment facilities” within the description of machinery and machinery parts used for water pollution control mechanisms.

Policy Considerations

This bill would provide a tax benefit for taxpayers filing under the Bank and Corporation Tax Law that would not be provided to other similarly situated taxpayers that file under the Personal Income Tax Law. Thus, this bill would provide differing treatment based solely on entity classification.

Implementation Considerations

This bill appears to create an ambiguity by including water treatment “facilities” in the type of water pollution control “mechanisms” that would qualify for the credit. Specifically, it is unclear whether a “facility” is the same as or a type of “mechanism.” This ambiguity leaves unclear whether the credit would be allowable only for machinery and machinery parts used for “mechanisms” or for entire “facilities.”

Once this implementation concern is resolved, implementing this bill would occur during the department’s normal annual system update.

FISCAL IMPACT

Departmental Costs

If the bill is amended to resolve the implementation consideration addressed in this analysis by clarifying the type of property to which the credit would be extended, the department's costs to administer the bill would be minor.

Tax Revenue Estimate

Revenue losses under the Bank and Corporation Tax Law are estimated to be minor (less than $500,000) annually.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The above estimate is based on information received from various agriculture contacts. They indicate that agricultural drain water treatment facilities would be primarily used by farmers. They also indicate that because of the large capital outlay for these treatment facilities, few farmers would invest in these infrastructures. Also many farmers have leased land where the investment incentive is likely to be marginal (indicating enterprise zones). Less than one percent of enterprise zone use is attributed to the agriculture industry.

BOARD POSITION

Pending.

ENTERPRISE ZONE TAX INCENTIVES

Sales or Use Tax Credit

The enterprise zone sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property purchased for exclusive use in an enterprise zone. The amount of the credit is limited to the tax attributable to enterprise zone income. Qualified property is defined as:

1. Machinery and machinery parts used for :
   A. manufacturing, processing, combining, or otherwise fabricating a product;
   B. the production of renewable energy resources; or
   C. air or water pollution control mechanisms.
2. Data processing and communication equipment.
3. Motion picture manufacturing equipment.

In addition, qualified property must be purchased and placed in service before the enterprise zone designation expires. The maximum value of property that may be eligible for the enterprise zone sales or use tax credit is $1 million for individuals and $20 million for corporations.

Hiring Credit

A business located in an enterprise zone may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated an enterprise zone and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the enterprise zone and at least 50% must be performed inside the enterprise zone. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on enterprise zone income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage. The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Business Expense Deduction

A business located in an enterprise zone may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the enterprise zone. The deduction is allowed in the taxable or income year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after Designation	Maximum Deduction
0 to 24	$40,000
25 to 48	30,000
48 and over	20,000

Net Operating Loss Deduction

A business located in an enterprise zone may elect to carry over 100% of the enterprise zone net operating losses (NOLs) to deduct from enterprise zone income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the enterprise zone.

Net Interest Deduction

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone, and the lender may not have equity or other ownership interest in the enterprise zone trade or business.

Employee Wage Credit

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of “qualified wages,” defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer’s entire taxable income.

Apportioning

For businesses operating inside and outside an enterprise zone, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the enterprise zone. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the enterprise zone using a two-factor formula based on the property and payroll of the business.